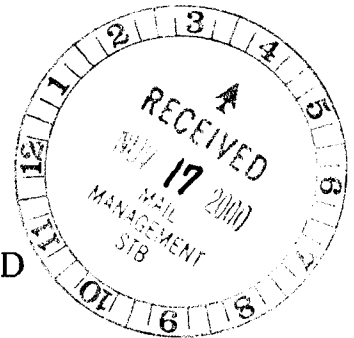


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HRRC-2

BEFORE THE  
SURFACE TRANSPORTATION BOARD

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Ex Parte No. 582 (Sub. No. 1)

COMMENTS OF  
  
HOUSATONIC RAILROAD COMPANY, INC.

NOVEMBER 17, 2000

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Edward J. Rodriguez  
General Counsel  
Housatonic Railroad Company, Inc.  
P.O. Box 687  
Old Lyme, Connecticut 06371  
(860)-434-4303

ORIGINAL

BEFORE THE  
SURFACE TRANSPORTATION BOARD

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Ex Parte No. 582 (Sub. No. 1)

COMMENTS OF  
HOUSATONIC RAILROAD COMPANY, INC.

INTRODUCTION AND BACKGROUND

Housatonic Railroad Company, Inc. is a Class III railroad operating in the states of Connecticut, Massachusetts and New York. It was a party of record in F.D. 33388, the acquisition of Consolidated Rail Corporation by Norfolk Southern Railway Company and CSX Transportation Company. As such, it acquired a first hand familiarity with the STB process for the approval of major rail consolidations and an appreciation of many of the Class III issues which are likely to arise in any major rail consolidation proceeding.

On March 31, 2000, in the above entitled action, the Surface Transportation Board served an Advance Notice of Proposed Rule Making regarding major rail consolidations and solicited comments and proposals on a wide range of merger related issues. Pursuant to that Notice, Housatonic Railroad Company, Inc., submitted comments on May 16, 2000, in which Housatonic offered its views on certain aspects of major rail consolidations as they affect Class II and Class III carriers.

On October 3, 2000, the Board issued a decision in STB ExParte No. 582 (Sub. No. 1). ("Decision") The Decision set forth proposed revisions to various sections of the regulations governing major rail consolidations as set forth in 49 C.F.R. Part 1180. The comments previously submitted by Housatonic are summarized in Appendix D of the Decision at Page 161.

Housatonic Railroad now offers these further comments on the proposed revisions to 49 C.F.R. Part 1180 as set forth in the Decision.<sup>1</sup>

As outlined in Housatonic Railroad's earlier comments in this proceeding, the importance and the role which Class II and Class III railroads play in the rail transportation network has changed significantly since the passage of the Staggers Act in 1980. During the intervening period, the whole complexion of the rail industry has changed. Class I railroads sought to enhance their profitability by spinning off light density marginal properties to Class III carriers. Major rail consolidations have increased the reach of long haul rail networks, at the same time diminishing the number of competing routes.

During that period, Class II and Class III carriers have become a vital and important component of the national rail transportation network. Class I carriers have tended to focus on their role as long haul carriers rather than as local service providers. However, Class I's have not abandoned their role as local service providers. They have, for the most part, retained local service on main line track and on high density branch lines, from which they often compete for local business with Class III carriers.

#### RELATIONSHIP OF CLASS I RAILROADS TO CLASS III RAILROADS

The relationship between Class I railroads and Class III railroads is complicated and in some ways contradictory.

Class III railroads are primarily local service providers and most interchange the bulk of their traffic with Class I railroads.

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<sup>1</sup> Housatonic Railroad submits these comments because it is interested in the public policy affecting the rail transportation system in the United States. These comments are not intended to describe and should not be construed as describing or relating in any way to the relationship between Housatonic Railroad and its Class I railroad connection.

Class I railroads provide two distinct and different types of transportation services. They are, first and foremost, the long haul "Network Providers". As such, they play a distinctive and unique role in the rail transportation system. In addition, they also provide local service and in that capacity serve the same function as Class III railroads ("Local Service Providers"). With respect to traffic which it neither originates nor terminates, a Class I railroad is an overhead carrier and Network Provider. With respect to traffic originating (or terminating) on the Class I and terminating (or originating) on a Class III, it is a Network Provider to the Class III and a Local Service Provider to its on-line customer.

As a Network Provider, the Class I is a supplier, or wholesaler, to the Class III, and a partner in the provision of rail transportation services. As a Local Service Provider, the Class I is often a competitor of the Class III for the same business.

For the majority of Class IIIs which have only one Class I connection, the monopoly power which can be exerted by the Class I railroad is significant. It exists in the form of a bottleneck which permits the Class I to control rates and routes. As both a competitor of the Class III and its only access to the general transportation network, the Class I can engage in significant anti-competitive conduct to the significant disadvantage of Class IIIs and their customers. Yet the Class III must work with the Class I as a partner in the development of transportation business.

The peculiar and conflicting aspects of the Class I/Class III relationship require review by the STB and the development of policies and procedures to ensure a fair, efficient, and non-discriminatory transportation system for Class IIIs and their customers. Those policies should be designed to ensure that Class I railroads do not use their monopoly power as Network Service Providers to compete unfairly with Class IIIs or to discriminate against them with respect to rates or service.

## MERGER EFFECTS UPON CLASS III RAILROADS

Class I railroads are natural monopolies which derived their initial franchise, and sometimes their property, by government act. The purpose and effect of a major rail consolidation is to combine and extend the monopolistic power of the acquiring railroad. While major rail mergers may enhance the competition between Class I railroads and other modes of transportation, such mergers are inherently anti-competitive with respect to rail to rail competition.

Class I shippers may be adversely affected by major rail consolidations, but the availability of other transportation modes may sometimes alleviate the anti-competitive consequences. Where it does not, the Board has tried to take appropriate steps to preserve the pre-merger level of competition.

The group of businesses most likely to suffer adverse consequences from a major rail consolidation are the Class III carriers affected by the consolidation. Unlike shippers, Class III railroads can not alleviate anti-competitive merger consequences by turning to other modes of transportation. However, until now, the Board and the merger regulations have not focused specifically upon the harm often caused to Class IIIs by Class I mergers. When relief was provided to Class III railroads, it was often justified by the harm to the Class III railroad shippers .

The failure to adequately protect the interests of Class III railroads in major rail consolidations was caused, in part, by a failure of the merger regulations to specifically identify Class III railroads as an integral part of the transportation network, the protection of which was required by public policy. It also resulted from a failure of the Board to view Class III railroads as customers or shippers of Class I railroads. In fact, Class III railroads are Class I customers, who, because of the nature of their businesses, are captive to rail. Finally, some viewed the merger harm to Class III railroads as resulting from increased competition and therefore not deserving of protection. However, Class III railroads do deserve protection from merger harms resulting from unfair competition caused by monopolistic, anti-competitive behavior of Class I railroads.

#### USE OF MONOPOLY POWER TO HARM CLASS III RAILROADS

There are many ways in which Class I railroads can improperly use their monopoly power as Network Providers to inflict harm upon connecting Class III railroads. When a Class III railroad is captive to a Class I railroad, in the sense that it has no meaningful alternative connection to the railroad network, the connecting Class I has the power to completely control rates, routing and service enjoyed by the Class III. The controlling Class I railroad can compete unfairly with the Class III by discriminatory or differential pricing to disadvantage a Class III railroad's local service relative to the local service of the Class I. This can be done by pricing the network service provided by the Class I to the Class III at a rate which is close to the rate charged by the Class I for its network and local service combined. That is, the Class I can insure that pricing for service to Class III stations is always higher than pricing to competing Class I stations, regardless of the relative efficiency of the local service provided by each carrier.

The competitive balance can best be achieved by requiring Class I Network Providers to price Network and Local services separately and by prohibiting them from using their network monopoly to extract monopoly profits. Class I railroads should be required to provide wholesale network services to Class III carriers at prices that reflect the marginal cost of providing the service plus a reasonable return to the Class I. Pricing of overhead services between a Class III and another carrier should not be used by the Network Provider to disadvantage one route compared to another nor to attempt to profit from Local Services provided by the Class III. Reasonable overhead rates should be provided to all gateways and other Class I interchange points. By requiring Class I railroads to provide such rates, Class III railroads will achieve effective access to other Class I carriers.

Class I carriers will assert that many of the issues and concerns raised in these comments exist even in the absence of a major rail consolidation. Indeed they do. However, these Class III issues should be addressed in the Board's consolidation procedure, together with specific transaction related harms, for two reasons.

First, as suggested above, a major rail consolidation extends and strengthens a government sanctioned monopoly. As a condition of approval of the transaction, and as a cost to the consolidating carriers of obtaining the private benefits of the transaction, it is reasonable to expect and require them to take reasonable measures to enhance rail competition. Public interest and the continued vitality of the railroad network require no less.

Second, many of the anti-competitive circumstances which existed before the proposed transaction are often exacerbated by the transaction. This occurs both because the monopoly power of the surviving Class I railroad is increased and because the surviving Class I railroad is often under substantial pressure to increase revenue to pay for the costs of the transaction, including implementation and capital costs.

One way of achieving added revenue is by anti-competitive predatory action directed at connecting Class III railroads. This can take the form of attempting to divert Class III local business to Class I stations, or to Class I distribution and inter-modal facilities, by anti-competitive rate practices.<sup>2</sup> It can also take the

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<sup>2</sup> Anti-competitive rate practices often consist of charging the Class III shipper a higher rate for network services than the network service component which is incorporated in the through rate charged by the Class I to its on line

form of increasing or establishing the Class I network service rate to the Class III at an unreasonable level which attempts to capture for the Class I , any profit component on the local service, whether such service is performed by the Class I or the Class III railroad.

There is no doubt that anti-competitive practices exist. Norfolk Southern Senior Vice President James McClellan is alleged to have predicted at a September, 2000 meeting of the Railroad Shipper Transportation Council that Class I railroad cost cutting and efficiency initiatives would doom most Class III connections, causing 80% of them to fail.<sup>3</sup> Indeed, in NS's earlier comments in this proceeding, as summarized in the Decision at page 130, NS complained that imposing any type of access condition would "undermine their ability to price their services differentially."

Housatonic Railroad urges the Surface Transportation Board to consider carefully the important role which Class II and Class III railroads play in the national railroad network in adopting new merger regulations. The Surface Transportation Board should use its authority over major rail consolidations to promote and enhance competition and a seamless rail transportation network by increasing competitive access of Class III railroads to other rail carrier connections and by requiring separate, competitive pricing of overhead services by Network Providers to Class III carriers. The Board should address other merger related harms, including compensation for losses sustained by Class III carriers as a result of poor Class I service caused by implementation of merger transactions.

Clearly, all issues addressed in these comments can not be adequately addressed in the merger context. Housatonic Railroad believes that the time has come for the Board to conduct a general inquiry into whether and under what circumstances it is appropriate for the Board to mandate competitive access and whether the Board should require fair and competitive pricing by Class I railroads of network services provided to their connections. Housatonic Railroad urges the

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customer. The Class I effectively captures the profit component on both the network services which it provides and the local service which is provided by the Class III railroad. The effect of this rate discrimination is either to divert traffic from the Class III or to permit the Class I to extract monopoly profits at the expense of the smaller railroad.

<sup>3</sup> Traffic World, September 13, 2000, at page 16.

Board to institute a separate proceeding to consider these issues.

COMMENTS ON SPECIFIC PROPOSED REVISIONS TO 49 CFR, PART 1180 AS DESCRIBED IN DECISION SERVED IN THIS PROCEEDING ON OCTOBER 3, 2000.

In the opinion of Housatonic Railroad, the Board has produced a very thoughtful and progressive proposal which addresses many of the Class III concerns in a general way. It is clear that the Board intends to seriously consider the effects of proposed major rail consolidation transactions on the entire rail transportation network, including Class II and Class III railroads. The explicit references to smaller railroads in the proposed regulations and in the accompanying comments are important and show a good understanding of most Class III concerns.

In addition, the emphasis on the three public benefit goals of improved service, enhanced competition and economic efficiency are appropriate and the proposed regulations reflect those public goals.

In short, the Board and its staff has done an impressive job of addressing the various constituencies and has appropriately included smaller railroads within those constituencies. However, as good as they are, the proposed regulations can be improved. Accordingly, Housatonic Railroad offers the general comments set forth above and the specific comments which follow.

GENERAL POLICY STATEMENT [Section 1180.1(a)]

Housatonic Railroad and various other parties submitting comments suggested that the STB direct particular and special attention to the role of Class II and Class III carriers in the transportation system and take account of that role in formulating merger policy. The Board has taken several important and significant steps towards achieving that recommended goal.

The general policy statement set forth in proposed Section 1180.1(a) states "The Board recognizes that the railroad industry (including Class II and Class III carriers) is a network of competing and complimentary components, which in term is part of a broader transportation infrastructure that also embraces the nation's



highways, waterways, parts, and airports.”

That policy statement is noteworthy not only because of the Board’s recognition of the important role that Class II and Class III carriers play in the transportation network, but also because of the Board’s recognition that they are competing and complimentary components. This policy statement implicitly recognizes the conflicting and contradictory relationships between Class I and Class III carriers commented upon by Housatonic. Housatonic enthusiastically supports the proposed revision to Section 1180.1(a) and is hopeful that the Board will interpret its policy statement broadly to address the unique role of Class III carriers in connection with major rail consolidations.

#### CONSOLIDATION CRITERIA [Section 1180.1(b)]

In proposed Section 1180.1(b) the Board sets forth consolidation criteria. The Board’s proposed revision is concise and to the point. When read together with proposed Section 1180.1(c) and Section 1180.1(c)(1), it becomes clear that the criteria encompass the public interest goals of improved service, enhanced competition, and greater economic efficiency. Furthermore, a review of the brief comment following proposed Section 1180.1(b) on page 12 of the Decision, makes clear that the Board would place greater emphasis on the role of Class II and Class III carriers in the broader transportation infrastructure.

Notwithstanding these clarifications, Housatonic respectfully suggests that the Board modify the language of proposed Section 1180.1(b) by adding language to the second sentence to read as follows:

“In determining the public interest, the Board must consider the various goals of enhanced effective competition, carrier safety and efficiency, improved service for shippers, environmental safeguards, fair working conditions for employees, and the impact on the railroad network (including Class II and Class III carriers)”.

#### PUBLIC INTEREST CONSIDERATIONS [Section 1180.1(c)]

In the proposed revision to Section 1180.1(c), the Board sets forth in some detail the public benefit goals of the rail transportation policy - improved service, enhanced competition, and greater economic efficiency. It is noteworthy that the

Board has stated "To maintain a balance in favor of the public interest, merger applications must include provisions for enhanced competition."

Housatonic supports and endorses this provision and also supports the other provisions of proposed Section 1180.1(c) and the comments which follow on Page 13 of the Decision. The attention to service disruption issues and the flexibility in achieving enhanced competition are important and positive ingredients.

Without detracting from the significant and important improvements incorporated in this provision, Housatonic respectfully suggests that the Board, in implementing the policy, increase its focus on the role of Class III carriers in enhancing competition, improving service, and promoting economic efficiency. Even the broad statements of flexibility and methods of enhancing competition seem to understate the role which Class III carriers can play as a vehicle for enhancing competition and the role which the Board can play in fostering these Class III functions.

#### POTENTIAL BENEFITS [Section 1180.1(c)]

The proposed provision to Section 1180.1(c)(1) is commendable, as far as it goes. The emphasis on the public benefit goals of improved service, enhanced competition, and greater economic efficiency are laudable. Unfortunately, the role of the Class III carrier as a vehicle for enhancing competition, promoting economic efficiency, and improving service is not explicitly recognized.

Housatonic Railroad respectfully suggests that the Board amend its proposed language of this Section to make clear that the potential public benefits of the merger apply not only to customers of the merging carriers, but to the railroad network as a whole, and give explicit recognition to the important role which Class II and Class III carriers can play in achieving public benefits.

#### POTENTIAL HARM [Section 1180.1(c)(2)]

Again, the Board's proposed Section 1180.1(c)(2) is commendable. The Board's statement that in analyzing potential harms "we must consider, but are not limited by, the policies embodied in the anti-trust laws", is enlightened and

welcome. While Housatonic does not favor a full application of the anti trust laws to railroad consolidations, the policy and well developed jurisprudence surrounding application of the anti-trust laws can enlighten and inform all participants in the rail consolidation process.

In considering harm to essential services, the Board observes that mergers should strengthen, not undermine the ability of the rail network to advance the nation's economic growth and competitiveness. However, the Board then focuses on the essential services test. In the past, application of that test has been somewhat narrow and confining. In applying the essential services test to Class II and Class III carriers, Housatonic respectfully suggests that the Board focus on effective and competitive essential service. Furthermore, the Board should consider potential harm to Class II and Class III carriers caused by major rail consolidations even if such harms do not result in the inability of the carrier to provide essential services. As set forth in more detail above, Housatonic does not advocate that the Board protect carriers from competition. Rather, Housatonic suggests that the Board should strive to preserve and expand the opportunities of Class II and Class III carriers to compete on a level playing field after the merger transaction is consummated.

CONDITIONS [Section 1180.1(d) ]

Proposed Section 1180.1(d) requires the Board to carefully consider conditions proposed by applicants. However, it does not require the Board to carefully consider conditions proposed by other parties, such as Class II and Class III carriers. In view of the previous policy of the Board in carefully considering such requests, the omission here may be an oversight. In any event, Housatonic respectfully requests that the language of Section 1180.1(d) be revised to include the requirement that the Board carefully consider conditions proposed by Class II and Class III carriers.

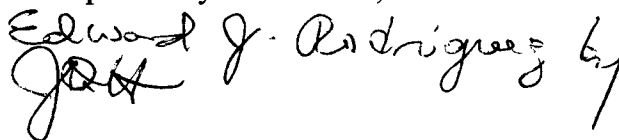
The last sentence of the proposed section in which the Board states that it seeks to enhance competition in ways that strengthen and sustain the rail network as a whole, including that portion of the network operated by Class II and Class III railroads, is a very positive statement which is consistent with the public benefits sought to be achieved by the merger.

On the other hand, the statement that "conditions are generally not appropriate to compensate parties who may be disadvantaged by increased competition." is viewed by Housatonic as unfortunate. It is unfortunate not

because it is untrue, but because of what it may be interpreted as meaning. While major consolidations may promote competition by enabling the surviving railroads to compete more effectively with other modes, a major rail consolidation is inherently anti-competitive with respect to intra modal competition. The intent and inevitable effect of a major rail consolidation is to expand and extend the monopoly power of the acquiring railroad. Class II and Class III railroads do not generally seek or require protection from enhanced fair competition created by major rail consolidations; rather they seek to participate in the new competitive environment. Class II and Class III railroads and their customers do require protection from existing and enhanced monopoly power of Class I railroads.

Major rail consolidations may have the effect of placing the resulting Class I carrier in direct competition with an existing Class II or Class III carrier. As discussed above, that situation, without regulation, can permit the resulting Class I carrier to use its monopoly power to unfairly compete with the Class II or Class III railroad. Some competition between Class I and Class III railroads is inevitable and may be beneficial to the customer. However, when the Class I uses its monopoly power as a network provider to the Class III to enable it to compete with the Class III, the resulting competition, if it can be called that, is unfair and tainted, and protective conditions in favor of the smaller carrier are warranted.

Respectfully submitted,

A handwritten signature in cursive script, appearing to read "Edward J. Rodriguez". The signature is written in dark ink and is positioned above the typed name.

Edward J. Rodriguez  
General Counsel  
Housatonic Railroad Company, Inc.  
P.O. Box 687  
Old Lyme, Connecticut 06371  
(860) - 434-4303

Certificate of Service

I hereby certify that a copy of the foregoing Comments has been served upon all parties of record.

  
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John Heffner, Esq.